A REPORT BY

THE 2011-2012 CONTRA COSTA COUNTY GRAND JURY

725 Court Street
Martinez, California 94553

Report 1209

City Retirement Plans

An Unsustainable Benefit?

APPROVED BY THE GRAND JURY:

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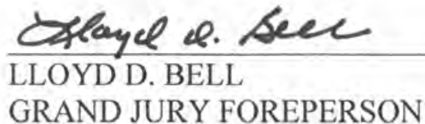

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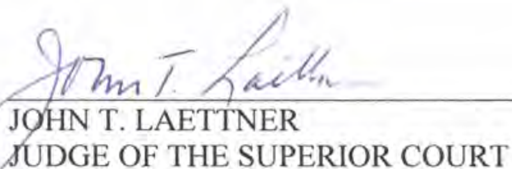

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Contra Costa County Grand Jury Report 1209

City Retirement Plans

An Unsustainable Benefit?

TO: Contra Costa City Mayors and Council Members

SUMMARY

The cost of public agency employees' retirement benefits has become a hot-button topic. Increased benefits granted during good economic times are now coming back to haunt local governments that are struggling to maintain public services. Cities are required to spend an increasing portion of their limited budget dollars to meet their retirement obligations. In a number of instances, cities have found that the increased cost of funding retirement benefits at current levels requires expenditures that limit their ability to maintain services to their citizens.

Sixteen of the cities in Contra Costa County (County) provide a defined benefit retirement plan to their employees and some may be facing unsustainable retirement plan costs. Some of these cities have made changes to their retirement plans to reduce their future costs, but a number have not. With or without changes, the near-term future indicates an increase in costs associated with retirement benefits. These costs may be of particular concern to residents of cities which have a large portion of their General Fund dollars committed to paying for employee retirements, which in some cases includes not only the cost of pensions, but life-time health-related benefits as well.

Three cities in the County provide a defined contribution retirement plan to their employees. These plans tend to limit unexpected future financial exposure by capping the city's contribution to the retirement plans.

In February 2012, the Governor's Twelve Point Pension Reform Plan (Governor's Pension Reform Plan) was released as a bill and a proposed constitutional amendment. The pension reform bill would take substantial steps to alter retirement benefits for new governmental employees, as well as eliminate some benefits for current employees. While not all aspects of the reform proposal may be applicable to all local governmental entities, it represents a good model for addressing the looming retirement obligation challenge.

BACKGROUND

Local governmental agencies have been experiencing difficult financial times over the past several years. Faced with the sharp decreases in revenue, many public agencies have had to reduce expenditures, resulting in loss of jobs and services. Unfortunately, some of the costs of doing business have not decreased, but have increased, absorbing a larger portion of the "budget pie" and thus reducing the funds available for public services. Public sector retirement plans

have received a lot of attention from the media and government officials, primarily due to their escalating costs.

Low investment returns have obligated public agency employers to increase their contributions to meet the financial obligations of current and prospective retirees. A recent report from the Government Accountability Office estimated that without policy changes, states and local governments would need to cut spending or raise taxes by 12.7% each year over the next five decades to keep their budget in balance. This is due in part to increasing expenses for public sector health care and under-funded pension plans. Governor Brown, Stanford University, the Little Hoover Commission, and local elected officials of all political persuasions have even called current retirement benefits for governmental employees "unsustainable."

Each city in the County funds some type of retirement plan for current and retired employees. There are two types of retirement plans offered by the County's cities: a defined benefit plan or a defined contribution plan.

Under a defined benefit plan, an employee, upon qualifying for retirement, receives a monthly pension based upon a formula as contracted by the city. State statutes provide limitations as to how such formulas are to be determined. This type of pension is a direct obligation of the city, and the city takes the risk for any shortfalls or losses.

Under a defined contribution plan the employer contributes a set amount, usually a percentage of salary, to an employee's individual account, which is managed by the employee. The employee may also contribute a percentage of their salary. Only the contributions are guaranteed, not the future benefits. It is up to the individual employee to make investment decisions and thus bear the risk for losses.

Whether they provide either a defined benefit or defined contribution plan, many cities also provide another form of a defined contribution plan, often called a deferred compensation plan. It allows the employee to contribute an amount from salary which is deferred from current taxation. In some cases, the city also may contribute an amount to match all or a portion of the employee's contribution. The employee directs the investment of these funds and the city has no liability to the employee other than what it might contract to contribute to the plan on behalf of the employee.

In order to compare the type and level of those benefits, the Grand Jury surveyed and received responses from all 19 cities. The survey and follow-up questionnaire collected data concerning retirement obligations, such as:

- Plan types
- Plan formulas
- Employee contributions, if any, to the plan
- Vesting requirements
- Retiree health options

In addition, the Grand Jury requested information concerning:

- Changes to the retirement plan in the past three years
- Forecasts of the city's retirement obligations over the next five years
- The percentage of General Fund dollars represented by total retirement costs

Of the 19 cities in the County, 16 provide a defined benefit pension plan for employees.

The three cities in the County that do not provide a defined benefit pension plan, Lafayette, Orinda and Danville, do provide employees with a defined contribution plan.

All of the 16 cities with a defined benefit plan are members of the California Public Employees Retirement System (CalPers), which is one of the largest public sector retirement plans in the country, with an investment portfolio market value of $228.7 billion, as of February 2012. CalPers provides retirement, health and related financial programs to more than 1.6 million public employees and more than 3,000 public employers.

CalPers offers public agencies the ability to provide a variety of retirement benefits and benefit levels to employees. Generally, employees are grouped as either Safety (sworn peace officers and firefighters) or Miscellaneous (all others not eligible for Safety). Monthly pension benefits obtained by qualified employees upon retirement are determined by multiplying the employee's pension eligible compensation (either the highest 12 consecutive months or a three year average) by the number of years of service, multiplied by the contracted percentage factor, which ranges from 2% of salary at age 60 to 3% of salary at age 60 for Miscellaneous and from 2% of salary at age 55 to 3% of salary at age 50 for Safety. Pensions may also be adjusted annually based upon cost of living adjustment (COLA) formulas, which range from 2% to 5% annually. In addition, the contribution the city pays toward the employee's CalPers share can also be counted as salary when calculating the employee's pension upon retirement.

As an example, a Martinez police officer who is eligible to retire at age 50 with 30 years of service would receive a pension equal to 90% of his or her pension-eligible compensation. But since the City paid the employee's 9% CalPers contribution, the 9% is added to compensation. Therefore, the retiree essentially is receiving over 98% of the single highest year of his or her compensation. In addition, the pension may be adjusted annually for life to reflect COLA.

A number of cities have modified future pension benefits to their employees by creating a second benefit level, or tier. A second tier (Tier 2) would only apply to new employees hired after the date that the second tier was adopted. In all cases, the new tier has lower benefits than offered under the terms of the original pension plan formulas. Tier 2 employees could have a lower formula, use three years instead of 12 months for calculating the highest salary amount, and/or require more contribution from the employee towards the benefits. The second tier is adopted separately for Safety and Miscellaneous employees.

For example, Miscellaneous employees hired on or after October 1, 2010 in the city of Brentwood receive a benefit based on the formula 2% at age 60 (2% @ 60), using a three year average for the highest salary versus the formula 2.7% at age 55 (2.7% @ 55) using the highest 12 consecutive month average salary for employees hired before that date. At the time of the writing of this report, no second tier has been adopted for Safety employees in Brentwood.

Based upon the data provided by the cities, the following table identifies the pension formulas used for each tier for each city with a defined benefit plan.

Table 1 Defined Benefit Pension Formulas and Tiers

City	Miscellaneous				Safety			
	Tier 1		Tier 2		Tier 1		Tier 2	
	Formula	Base Salary	Formula	Base Salary	Formula	Base Salary	Formula	Base Salary
Antioch	2.7% @ 55	High 12	2.0% @ 55	High 12	3.0% @ 50	High 12		
Brentwood	2.7% @ 55	High 12	2.0% @ 60	3 yr avg	3.0% @ 50	High 12		
Clayton	2.0% @ 55	3 yr avg	2.0% @ 60	3 yr avg	3.0% @ 55	3 yr avg	2.0% @ 50	3 yr avg
Concord	2.5% @ 55	High 12	2.0% @ 55	High 12	3.0% @ 50	High 12		
El Cerrito	2.7% @ 55	High 12			3.0% @ 50	High 12		
Hercules	2.0% @ 55	3 yr avg			3.0% @ 50	High 12	3.0% @ 55	High 12
Martinez	2.0% @ 55	High 12			3.0% @ 50	High 12		
Moraga	2.0% @ 55	3 yr avg			2.0% @ 50	3 yr avg		
Oakley	2.5% @ 55	High 12	2.0% @ 60	High 12	N/A	N/A	N/A	N/A
Pinole	2.5% @ 55	High 12			3.0% @ 55	High 12	2.0% @ 50	High 12
Pittsburg	2.0% @ 55	High 12	2.0% @ 60	3 yr avg	3.0% @ 50	High 12	3.0% @ 55	3 yr avg
Pleasant Hill	2.0% @ 55	High 12	2.0% @ 60	3 yr avg	3.0% @ 50	High 12	3.0% @ 55	3 yr avg
Richmond	2.7% @ 55	High 12			3.0% @ 55[1] 3.0% @ 50	High 12		
San Pablo	2.5% @ 55	High 12			3.0% @ 50	High 12		
San Ramon	2.7% @ 55	High 12			3.0% @ 50	High 12		
Walnut Creek	2.0% @ 55	High 12	2.0% @ 60	3 yr avg	3.0% @ 55	High 12		
Danville	Employees retirement plans are defined contribution, not defined benefit							
Lafayette	Employees retirement plans are defined contribution, not defined benefit							
Orinda	Employees retirement plans are defined contribution, not defined benefit							

[1]Firefighter formula is 3% @ 55. Police formula is 3% @50

KEY POINTS

- Five cities (Antioch, Brentwood, El Cerrito, Richmond and San Ramon) provide the highest benefit for Miscellaneous employees. They use a 2.7% at age 55 formula, based on the highest 12 consecutive months of salary.
- Eight cities have created a second tier with a less generous benefit formula for Miscellaneous employees.
- All cities, except Clayton, Pinole, Walnut Creek and Richmond (firefighters only) offer 3% at age 50 for Safety employees. These four cities use a reduced benefit of 3% at age 55.
- Five cities (Clayton, Hercules, Pinole, Pleasant Hill and Pittsburg) have taken steps to reduce pension benefits by creating a second tier for Safety employees.
- Six cities (El Cerrito, Martinez, Moraga, Richmond, San Pablo and San Ramon) have not reduced the benefits of either Safety or Miscellaneous employees.

To demonstrate the future impact of Tier 2 formulas on retirement benefits, the cities of Brentwood and Pinole offer examples for Miscellaneous and Safety employees. The table below shows the net difference for these two cities using otherwise identical calculation criteria. The percentage amounts and retirement ages used were provided by those cities. This table does not include any COLA adjustments which normally increases the lifetime retirement payout. However, even without COLA adjustments, the impact of a Tier 2 formula can be seen.

Table 2 Impact of Second Tiers

City / Employee Group	Formula	Percent	Retirement Age	Annual Retirement Income	Lifetime Benefit	Reduced Lifetime Amount
Brentwood / Miscellaneous	Old	2.7%	55	$48,600	$1,215,000	
	New	2.0%	60	$36,000	$720,000	**($495,000)**
Pinole / Safety	Old	3.0%	55	$81,000	$2,430,000	
	New	2.0%	50	$54,000	$1,620,000	**($810,000)**

Calculation Criteria

$60,000	Miscellaneous group salary at retirement
$90,000	Safety group salary at retirement
30	Years of service at retirement
ZERO	COLA adjustment in calculations
Age 80	Assumed Lifespan

Under CalPers guidelines, both the employer and employee have prescribed contribution rates, paid as a percentage of salary. Generally the employee's share varies from 7% to 10% of salary. As noted above in the example of calculating the retirement amount for a police officer in Martinez, the amount of employee share paid by the employer is added to his or her salary. Over

the years, employees of many local governments have negotiated to have the employer pay all or a portion of the employee's share of pension cost. Some cities have the employee pay a portion of the **employer's** contribution, thereby continuing to add to the employee's share for the purpose of basing the pension on a higher salary.

Martinez was the only city to report that none of their employees contribute towards the employee's share. Several other cities indicated that certain groups are not required to pay towards the employee's share. On the other end of the spectrum, Pinole reported that employees pay all of the employee's share, as well as a portion of the employer's contribution.

The employer's contribution rate changes from year to year, depending upon an actuarial valuation, which is calculated to cover the normal costs, as well as any unfunded liabilities from previous years. The unfunded liability is what the actuary determines as the cost to cover shortfalls from market losses, demographic changes, overly optimistic estimates of investment returns by CalPers or other benefit improvements that were not covered by the contribution rates collected from the employee and employer. Employees do not share any of the unfunded liability burden. It is only recovered through additional charges to the employer. In other words, each city is responsible for any deficit the defined benefit plan may experience and ultimately its taxpayers suffer consequences in the loss of services.

Another retirement benefit that has been offered in many cities is retiree health care. Health care costs have seen substantial increases over the past decade. Since 2001, employer-sponsored health coverage cost for family premiums has increased by 113%. CalPers approved a 2012 health rate package that will increase overall premiums by only 4.1%, as compared to the latest national overall premium increase of 9% for 2011. Although efforts have been made to contain health care costs, it is uncertain what the future holds. In November 2011, the State Supreme Court ruled that government retirees have a vested right to health benefits if state and local governments clearly promised those benefits as part of employment agreements.

Retiree health care can include medical, dental, and vision care. Once an employee is vested in a city's retiree health benefit, which can range from the first day of employment to 20 years of service, the employee and sometimes his or her spouse and qualified dependents are eligible to continue receiving lifetime health coverage. In some cities, this benefit is paid all or partly by the employer. Some cities only offer the retiree the opportunity to continue under the city's group rates. Cities such as San Ramon, Pittsburg, Martinez, Richmond (safety), Pinole (employees hired prior to September 2010) and Brentwood pay 100% of the cost of health care if the employee is vested. In Martinez, Safety employees vest immediately upon employment for lifetime medical benefits upon retirement.

It was also noted that all cities with a defined benefit plan also offer a deferred compensation plan. This deferred compensation plan allows employees to contribute pre-tax dollars (currently up to $22,500 per year) from salary to a supplemental retirement plan. Many cities also contribute or match employee contributions to the deferred compensation plan.

Cities were requested to provide a five-year projection of retirement obligations. Many cities anticipated large increases in retirement costs in the next five years. Some of the cities indicated they could not forecast the cost of retirement for the next five years and either provided a shorter

projection of costs or none at all. No city anticipated a reduction in the cost for retirement obligations over the next five years.

The next table identifies those cities which provide retiree health insurance as an additional benefit, cities in which the employer contributes to the defined compensation supplemental retirement plan, and the percent of General Fund dollars that are allocated to total retirement costs in the current fiscal year.

Table 3 Other pension benefits and General Fund allocation for total retirement costs

CITY	Retiree Health care?	City Contributes to Defined Contribution (Deferred Compensation) Plan?	Percent of General Fund For Total Retirement Costs
Antioch	Yes	No	**16.00%**
Brentwood	Yes	Yes[2]	**13.10%**
Clayton	Yes	No	10.40%
Concord	Yes	Yes	**13.89%**
Danville	No	Yes[3]	5.02%
El Cerrito	No	Yes[4]	**21.40%**
Hercules	Yes	Yes	8.98%
Lafayette	Yes	Yes[3]	8.10%
Martinez	Yes	Yes	11.30%
Moraga	No	Yes	7.40%
Oakley	No	No	2.25%
Orinda	Yes	Yes[3]	3.50%
Pinole	Yes	No	**24.60%**
Pittsburg	Yes	Yes	**20.00%**
Pleasant Hill	No	Yes	**25.00%**
Richmond	Yes	No	10.20%
San Pablo	Yes	No	**13.00%**
San Ramon	Yes	No	**14.00%**
Walnut Creek	Yes	Yes[5]	**13.00%**
Average %			**12.69%**

[2] For some management
[3] Employees don't have defined benefit plan
[4] City Manager Only
[5] Contributions for Miscellaneous employees will range from $335 to $2,500 as of 6.22.2012

KEY POINTS

- Five cities do not offer retiree health care to their employees. Those cities are Danville, El Cerrito, Moraga, Oakley and Pleasant Hill.
- Seven cities do not contribute to the employee's defined contribution (deferred compensation) plan. These are Antioch, Clayton, Oakley, Pinole, Richmond, San Pablo and San Ramon.
- Retirement obligations represent a low of 2.25% of the General Fund budget in Oakley, to a high of 25% in Pleasant Hill. (Note that Oakley has neither unions nor safety employees). For all 19 cities, the average percentage of the General Fund budget dedicated to pension costs is 12.69%.
- Danville, Lafayette, and Orinda, which provide defined contribution retirement plans, allocate some of the lowest percentages of their General Funds for retirement costs.

Governor's Pension Reform Plan

In an attempt to address the looming state-wide public employee pension crisis, the Governor released his Pension Reform Plan in October 2011. This was subsequently released as proposed legislation and a proposed constitutional amendment in February 2012. In general, the Governor's proposal applies most changes to new employees to reduce future pension cost. Some of the key points of the Governor's Pension Reform Plan that may apply to cities are as follows:

- Mandates the use of a "hybrid" pension plan (combination of a defined benefit and defined contribution plans) for all new employees hired on and after July 1, 2013. It would be the only plan that a public employer could offer to its employees.
- The new plan targets a benefit after a full career (defined as 30 years for a safety employee and 35 years for a miscellaneous employee) at 75% of final compensation, with a cap generally equal to the Social Security wage base. The full benefit would not be payable for a safety member who retires before age 57 and a miscellaneous employee member who retires before 67.
- Requires the use of three years for calculating final compensation for new employees. This is an attempt to stop salary spiking in the final year of employment. It also limits the definition of compensation as the normal rate of base pay, excluding special bonuses, payouts for unused vacation or sick leave and other pay perks.
- Eliminates the purchase of up to five years of additional service credit, commonly referred to as "airtime", for current employees and new hires. For example, a qualifying employee with 20 years of service could purchase an additional five years of service credits for a total of 25 years of service.

- All employees would be required to pay at least 50% of the annual normal cost of their pension benefits.
- Prohibits retroactive benefit enhancements. Any enhancement will apply only for future service and not to service before the date of the enhancement for new employees and to current employees to the extent possible under the California and U.S. Constitutions.

FINDINGS

1. Without additional revenue, continued increases in retirement costs may result in further reduction of public services.
2. In some cases, retirement costs consume a large proportion of a city's General Fund budget, thus limiting funding for discretionary spending.
3. Cities that have implemented lower pension formulas for new hires (Tier 2) have reduced their overall future pension obligations.
4. Although CalPers administers the defined benefit pension plans, including the investment programs, cities have some flexibility to control their own retirement costs.
5. Safety employees have significantly more generous retirement benefits than Miscellaneous employees, yet few cities have lowered benefits for new Safety hires.
6. Retiree health care may represent a significant future cost for those cities that pay for all or a portion of those benefits.
7. Defined contribution retirement plans can be an effective way to limit both current and future retirement costs.
8. The Governor's Pension Reform Plan offers a good strategic model for limiting future retirement costs for local governments.

RECOMMENDATIONS

1. Those cities that have not adopted a second tier with reduced pension benefits for their Safety employees should consider doing so.
2. Those cities that have not adopted a second tier with reduced pension benefits for their Miscellaneous employees should consider doing so.
3. In order to control unpredictable future expenses, cities should consider reducing or eliminating their financial obligation for retiree health care for future employees.
4. Cities should review the key points of the Governor's Pension Reform Plan, and consider incorporating its points as a long term strategy for addressing retirement costs.

REQUIRED RESPONSES

	FINDINGS								RECOMMENDATIONS			
	1	2	3	4	5	6	7	8	1	2	3	4
City of Antioch	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓
City of Brentwood	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓
City of Clayton	✓		✓	✓		✓	✓	✓			✓	✓
City of Concord	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓
Town of Danville	✓						✓	✓				✓
City of El Cerrito	✓	✓	✓	✓	✓		✓	✓	✓	✓		✓
City of Hercules	✓		✓	✓		✓	✓	✓		✓	✓	✓
City of Lafayette	✓					✓	✓	✓			✓	✓
City of Martinez	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Town of Moraga	✓		✓	✓	✓		✓	✓	✓	✓		✓
City of Oakley	✓		✓	✓			✓	✓				✓
City of Orinda	✓					✓	✓	✓			✓	✓
City of Pinole	✓	✓	✓	✓		✓	✓	✓		✓	✓	✓
City of Pittsburg	✓	✓	✓	✓		✓	✓	✓			✓	✓
City of Pleasant Hill	✓	✓	✓	✓		✓	✓	✓				✓
City of Richmond	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
City of San Pablo	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
City of San Ramon	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
City of Walnut Creek	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓

"✓" indicates a Required Response